MINUTES
of the
THIRD MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

September 9, 2014
Room 307, State Capitol
Santa Fe

The third meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2014 interim was called to order by Representative Jim R. Trujillo, chair, on Tuesday, September 9, 2014, at 9:45 a.m. in Room 307 of the State Capitol in Santa Fe.

Present
Rep. Jim R. Trujillo, Chair
Sen. George K. Munoz, Vice Chair
Sen. Sue Wilson Beffort
Sen. Jacob R. Candelaria
Rep. Larry A. Larrañaga
Sen. Steven P. Neville
Sen. Bill B. O'Neill
Rep. Jane E. Powdrell-Culbert
Rep. Luciano "Lucky" Varela

Absent
Sen. Carroll H. Leavell
Rep. William "Bill" R. Rehm
Rep. Henry Kiki Saavedra
Sen. William P. Soules

Advisory Members
Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Stuart Ingle
Sen. John C. Ryan

Rep. William "Bill" J. Gray
Rep. Emily Kane
Sen. Timothy M. Keller
Rep. Tim D. Lewis
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Sen. William H. Payne
Sen. Michael S. Sanchez
Rep. Sheryl Williams Stapleton

Staff
Lisa Sullivan, Staff Attorney, Legislative Council Service (LCS)
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS
Ric Gaudet, LCS
Celia Ludi, Staff Attorney, LCS

Guests
The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

Tuesday, September 9

Alternative Investments — Costs and Benefits

Steven K. Moise, state investment officer (SIO), State Investment Council (SIC); Vince Smith, deputy SIO, SIC; David Abbey, director, Legislative Finance Committee (LFC); Russell Cummins, executive director, New Mexico Small Business Investment Corporation (SBIC); Brian Birk, managing partner, Sun Mountain Capital; and Roxanna Meyers, chair, SBIC, gave presentations to the committee about various types of alternative investments in which the SIC engages. Mr. Moise introduced the panel and reported that the total assets under SIC management for fiscal year 2014 reached a record level of $19.8 billion, with a 15.9 percent annual investment return for that year.

SIC

Mr. Smith discussed the historical and current investment strategy of the SIC. Historically, most institutional investors followed a 60/40 approach to investing: 60 percent stocks and 40 percent bonds and cash investments. Today, most investors, including the SIC, use a more diversified investment strategy that reduces the percentage of stocks and bonds in favor of some investment in real estate, hedge funds, real return and private equity. The SIC has been shifting its investment strategy for several years, but that effort increased beginning in 2009 with the appointment of the current SIO and restructuring of the council. Previously, the SIC had a maximum commission for its contract investors of 25 basis points (.25 percent), which most high-yielding investors regarded as too low. Consequently, the SIC only had mediocre investors with average returns.

The SIC invests about 10 percent of the Land Grant Permanent Funds (LGPF) and 15 percent of the Severance Tax Permanent Fund (STPF) into private equity. Of that percentage, one-third of the STPF's investments are allocated toward New Mexico private equity, and a minimal amount of the LGPF is allocated for that purpose. These investments in New Mexico, called economically targeted investments (ETIs), have had a negative impact on the overall investment returns of the STPF. The SIC used to offer zero-percent loans for film companies wishing to film in the state plus a portion of the profits. The SIC has yet to realize any positive revenue from those investments. It now only offers market-rate loans for New Mexico films. The SBIC, in which the SIC invests about $40 million annually, no longer offers venture capital investments, preferring instead loans for small businesses. Finally, the SIC now only invests in New Mexico firms that have a good chance of returning market-rate returns, rather than the previously lower expectations of returns in exchange for economic development.

Questions and comments from committee members included the following.

- There was a bill in 2013 to require the SIC to invest in more university-generated ETIs.

Was the SIC in support of that bill? Charles Wollman, public information officer, SIC, said that legislation to target .25 percent of the STPF toward university technology ventures would be reintroduced in the upcoming legislative session. Mr. Moise said that there would be no guarantee that these kinds of investments would generate any returns for the state's trust funds, which is why the SIC is wary of being required to make such investments.

• The SIC is asking the legislature for substantial increases in contractual services for fiscal year 2016, but it is unclear whether those increases can be justified by demonstrating higher earning potential.

• Is having five percent of the STPF invested in New Mexico private equity an adequate percentage? The Association of Commerce and Industry of New Mexico recently called on the SIC to invest in more New Mexico companies. Mr. Smith said that the SIC has the statutory authority to invest up to nine percent of the STPF in such ventures. Sun Mountain Capital, the SIC's consultant about New Mexico private equity, has determined that currently there is only about five percent capacity to invest responsibly in New Mexico firms. Mr. Birk said that there is often a trade-off between investment returns and job creation in private equity investment decisions.

• As the state's permanent funds keep growing, the state should use a portion of those funds to improve New Mexico's economy and educational system.

• Investments in private equity should include clawback provisions if the investments fail. Mr. Birk said that New Mexico equity investments use nationwide investment standards. Including clawback provisions in such investments would seriously limit the ability of New Mexico businesses to attract capital.

• The SIC should also focus on loans to mid-sized New Mexico companies that need up to $1 million, since major banks tend to ignore that sector. Mr. Birk agreed and mentioned that the primary purpose of the SBIC is to provide such loans to businesses.

• How does the SIC ensure that it is not investing in equities that unduly harm people or the environment? The SIC should not get an investment return based on the misery of other people. Mr. Smith said that the SIC does not have a policy regarding socially responsible investments, but it does due diligence in hiring responsible asset managers.

<u>SBIC</u>

Ms. Meyers and Mr. Cummins discussed the activities of the SBIC, which is funded by a one percent allocation of the STPF in order to create new job opportunities across the state. Ms. Meyers said that the SBIC had previously lost money by investing in private equity and had also lost money through its loan participation agreement with Accion New Mexico. The SBIC now only loans money rather than investing, and it amended its agreement with Accion to minimize loss potential. After four years of losses, the SBIC earned $490,000 in fiscal year 2013 and will probably show net income for fiscal year 2014.

Since its inception, the SBIC loan program has earned money and created more than 8,000 jobs. Compared to other job incentive programs that cost the state as much as $30,000 per job created, the loan program has earned $88.00 per job created. The SBIC is not charged with receiving market-rate returns from its investments but is charged with helping to create jobs.

The SBIC recently partnered with the New Mexico Mortgage Finance Authority (MFA) to help create affordable housing in the high-job-growth area of Lea County. The lack of affordable housing in that county is actually slowing job growth. The MFA identified the area as needing more multifamily housing units and approached the SBIC to assist it with the financing. In this arrangement, the MFA has assumed all of the financial risk of the program.

The SBIC will need another infusion of money by the end of the year in order to expand its loan program. It will soon exhaust all of its available capital for the loan program, which will mean that potential borrowers will have to wait until other loans are paid off before being able to receive a loan.

Questions and comments from committee members included the following.

• Taos County also has a shortage of affordable housing, which may affect future job growth. Ms. Meyers said that the SBIC is always looking for new opportunities across the state to assist in job creation. The partnership with Lea County is not limited to that county only.

• SBIC staff was requested to provide the committee with the dollar value invested per county, the number of loans per county and details of the losses that the SBIC incurred in the past several years.

New Mexico Private Equity Investment Program

Mr. Birk reviewed the SIC's New Mexico private equity investment program. The program, created in 1993, used to be managed as a differential rate program designed for job creation rather than for returns. In 2004, the program's primary focus changed to financial return, which has resulted in significantly better returns. Currently, the SIC has allocated five percent of the STPF toward New Mexico private equity, with about $30 million to $40 million invested annually. The program's impact on New Mexico's economy has been substantial, with 67 New Mexico-based companies receiving investments and an estimated multiplier effect of more than $2 billion of capital being invested in those companies.

Questions and comments from committee members included the following.

• How much money was invested in the New Mexico private equity program when its primary focus was economic development? Mr. Birk said that prior to 2004, $120 million was invested; since then, about twice that amount has been invested.

• In addition to SIC investment in ETIs, the state should spend general fund money on those investments to encourage job growth and economic development.

• What kind of placement fees, if any, have been involved in the selection of firms in which to invest? Mr. Birk said that Sun Mountain Capital has never been involved with any funds or firms that used third-party marketing placement agents. No placement fees have been paid in the selection of investments.

LFC Report

Mr. Abbey reported to the committee on the historical change of the SIC's investment strategy toward more alternative investments. Before 2004, public pensions and other institutional investors largely invested in stocks and bonds. Since then, pension managers have looked toward other kinds of investment, including private equity, hedge funds and real estate, in order to optimize the risk-versus-return ratio. However, these kinds of investments tend to have higher fee structures and profit-sharing requirements than traditional investments.

Other large institutional investors, such as the California public employee retirement system and Yale University, have recently reduced their private equity investments and increased their fixed-income investments. New Mexico's retirement funds and the SIC seem to be heading in the opposite direction. However, although New Mexico's funds are increasing their exposure to private equity, their percentage of private equity investments are still far below other large institutional investors' levels.

Questions and comments from committee members included the following.

- An SIC member recently resigned because he believed that the return target of 7.75 percent was too high and unrealistic for the long term.

Approval of Minutes

The minutes from the July 28, 2014 IPOC meeting were approved without changes.

New Mexico Retiree Health Care Authority (RHCA) Status Report and Updates

Mark Tyndall, executive director, RHCA, gave the committee an update of RHCA investment earnings and the solvency status of the Retiree Health Care Fund. At the end of fiscal year 2014, the fund balance was nearly $377 million and earned 12 percent for that year. The SIC invests the fund for the RHCA, but the RHCA provides, through its contract consultant NEPC, asset allocation ranges. The RHCA has a constant need for liquidity in a portion of the fund in order to pay for insured claims, so it has a higher investment in liquid assets than a permanent trust fund would typically have. The fund currently has about 67 percent invested in equities and the remainder in bonds. The SIC has recently begun to allow its client agencies to invest a portion of their portfolios in alternative assets, into which the RHCA is looking.

The RHCA pays no management fees to the SIC for its services. It does pay fees indirectly to the SIC's asset managers as a percentage of revenues earned. In fiscal year 2014, the RHCA paid $853,000 on assets of $376 million, or 22 basis points. This low fee rate is because the SIC's much larger portfolio enables it to negotiate lower rates with asset managers.

Since 2007, when the RHCA began reforming its insurance program to increase the fund's solvency, the program's unfunded liability has been reduced $500 million to $3.6 billion. In addition, the fund has grown by $250 million, and the solvency period has increased from seven years to today's 19 years. The RHCA board recently approved further solvency measures, including:

- increasing all pre-Medicare rates by eight percent and Medicare supplement rates by five percent;
- reducing the pre-Medicare spousal subsidy by two percent;
- instituting a minimum age of 55 in order to receive any subsidy for most new retirees after 2019;
- increasing the years of service required for the maximum subsidy from 20 to 25 for most new retirees after 2019;
- converting current $6,000 basic life insurance policies to supplemental life insurance and phase out that subsidy beginning in 2017; and
- proposing legislation to increase employee contributions .375 percent over a three-year period and increasing employer contributions .75 percent over the same period.

If the RHCA proposals are fully implemented, the solvency period for the fund would be extended through 2040.

Educational Retirement Board (ERB) Status Reports and Updates

Jan Goodwin, executive director, ERB, Bob Jacksha, chief investment officer, ERB, and Allan Martin, partner, NEPC, presented an update on the ERB's activities and investment allocations. Investment earnings from the Educational Retirement Fund for fiscal year 2014 were approximately $1.46 billion, a return of 14.5 percent. For the previous five years, investment returns were 12.6 percent. The fund reached an all-time high on June 30, 2014 of $11.3 billion. The ERB has set an expected rate of return of 7.75 percent in order to meet actuarial liabilities in the future. The secondary goal of management of the fund is to decrease volatility through diversification, which is achieved by proper asset allocation.

NEPC and ERB staff recommended that the current asset allocation strategy be slightly modified to decrease public equity investments by two percent to 35 percent of the fund; decrease fixed-income investments by one percent to 28 percent of the fund; and increase alternative investments such as private equity, real estate and real assets by three percent to 26 percent of the fund. The NEPC recommendation also divests completely the ERB's investment in hedge funds.

Questions and comments from committee members included the following.

- How is the ERB's Governmental Accounting Standards Board (GASB) report going to look compared to fiscal year 2013's report? Ms. Goodwin said that the June 13, 2013 net pension liability statement said that the ERB was 60.1 percent funded. The actuarial report for this year is not yet finished, but it will have an even higher funded ratio.
- Why did the Public Employees Retirement Association (PERA) see a major increase in its funded ratio after the reform legislation of 2013, but the ERB saw only a modest increase? Ms. Goodwin said that the PERA was able to implement an immediate, permanent reduction in the cost-of-living allowance (COLA) from three percent to two percent. The ERB COLA

reduction is not a permanent reduction in statute, so the actuarial valuation of the reduction has to be taken using a different methodology.

• Can the Educational Retirement Fund ever get to a funded ratio of 90 percent if the investment target of 7.75 percent is not met? Ms. Goodwin said that the 90 percent goal can only be met by achieving those investment targets.

• The legislature should have funded the Educational Retirement Fund after the economy recovered in 2011 to make up for the planned employer contribution level increases that never happened.

• Will the new accounting requirements of the GASB pose any problems in the next few years? Ms. Goodwin said that with the new requirement to use a snapshot discount rate valuation of the fund, rather than a "smoothed" five-year average, the funded ratio probably dropped by five percent from 67 percent. However, the ERB is not required to use a blended rate of corporate bond and the discount rates, which would have reduced the funded ratio even more.

Adjournment

There being no further business, the IPOC adjourned at 2:05 p.m.